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No. 96-1127

In the Supreme Court of the United States

OCTOBER TERM, 1996

UNITED STATES OF AMERICA, PETITIONER

v.

EXXON CORPORATION AND SUBSIDIARIES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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1. Respondent erroneously asserts (Br. in Opp. 7) that the question presented in this case lacks continuing importance because the statutory percentage depletion deduction for oil and gas was repealed in 1974. As we explain in the petition, the percentage depletion deduction remains in effect (i) for natural gas sold by any producer under a contract in effect since 1975 (26 U.S.C. 613A(b)) and (ii) for sales of oil and gas made by "independent producers and royalty owners" (26 U.S.C. 613A(c)). See Pet. 5 n.1. Because of these two continuing applications of the percentage depletion deduction, the question presented in this case has substantial, recurring importance.

a. Large producers, such as Exxon, who sell natural gas under contracts in place since 1975, are still able to benefit from the percentage depletion deduction. Indeed, Exxon does not dispute that more than $1 billion in taxes

is at stake in the correct calculation of the percentage depletion deduction with respect to the audits and pending litigation involving respondent alone.

b. In addition, the question presented in this case has substantial recurring importance for the numerous "independent producers and royalty owners" for whom the percentage depletion deduction remains available for sales of oil and gas. Prior to 1974, these smaller producers would typically not have been able to arrange sales of their production away from the premises of the producing well. As a result, the depletion deduction available to small producers prior to 1974 was, as Exxon notes, normally "calculated under the first sentence of the regulation using the actual wellhead sales price" (Br. in Opp. 8). See also Pet. 5-6.

Beginnning in 1974, however, the Federal Energy Regulatory Commission promulgated a series of regulations that enabled small producers to sell their production directly to end-users, or in other distant markets, by requiring pipeline companies to act as common carriers in the transport of natural gas. See, *e.g.*, *General Motors Corp.* v. *Tracy*, No. 95-1232 (Feb. 18, 1997), slip op. 3-4; *United Distribution Cos.* v. *FERC*, 88 F.3d 1105, 1121-1127 (D.C. Cir. 1996), petition for cert. pending, No. 96-1186 (filed Jan. 27, 1997); *Associated Gas Distributors* v. *FERC*, 824 F.2d 981, 993-996 (D.C. Cir. 1987), cert. denied, 485 U.S. 1006 (1988). Because independent producers are now able to sell natural gas away from the wellhead, the amount of their depletion deduction for such sales is now controlled by the *second* sentence of the regulation—the sentence that this case involves—that requires consideration of the "representative market or field price" of the gas (26 C.F.R. 1.613-3(a)). The question presented in this case will thus continue to affect the returns of numerous

taxpayers and to implicate substantial tax revenues each year.

2. Respondent claims that the petition should be denied because there is not yet a direct appellate conflict on the question presented (Br. in Opp. 7). But we have not argued that the petition should be granted because of an existing conflict among the circuits. Instead, the petition should be granted because it seeks review of a decision of the Federal Circuit that concerns a recurring issue of substantial fiscal importance. Because the Federal Circuit is a court of nationwide jurisdiction and any taxpayer may pay a tax and sue for a refund in that circuit, it is unlikely that other courts of appeals will have an opportunity to review this same issue in subsequent cases. This Court has, for this reason, therefore frequently undertaken plenary review of Federal Circuit decisions of recurring fiscal importance. See, *e.g.*, *United States* v. *Hill*, 506 U.S. 549 (1993); *United States* v. *Goodyear Tire & Rubber Co.*, 493 U.S. 132, 138 (1989); *United States* v. *American Bar Endowment*, 477 U.S. 105, 109 (1986).

Moreover, as we discuss in detail in the petition (Pet. 15-16), the Tax Court has decided precisely the same question presented in this case and has *rejected* the very contentions that the Federal Circuit accepted in this case. In *Exxon Corp.* v. *Commissioner*, 102 T.C. 721, 743 (1994), the Tax Court held that, although the language of the regulation was inherently ambiguous, its origin and history reflect that a taxpayer may *not* claim percentage depletion based on a representative price that (as in the present case) substantially *exceeds* the price that the taxpayer in fact received. The opinion of the Tax Court involved the calculation of the percentage depletion deduction for a different tax year of this same taxpayer; it is

thus obviously and directly in conflict with the decision of the Federal Circuit in this case.[1]

The Tax Court, like the Federal Circuit, has a nationwide jurisdiction over tax claims. The conflict that exists between these two courts on the question presented in this case creates an incongruous situation—(i) taxpayers (like Exxon) who can afford to pay the tax and sue for a refund will prevail in a suit brought in the Federal Circuit; but (ii) taxpayers who lack the financial resources to pay the tax before suit—and who therefore must bring their challenge in Tax Court—will lose their case in the latter court.[2] The resulting inequality in

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[1] Exxon strangely suggests that the conflict between the decision of the Federal Circuit in this case and the decision of the Tax Court in *Exxon Corp.* v. *Commissioner*, *supra*, "does not bear on the question presented in the petition" (Br. in Opp. 9). The Tax Court not only disagreed with the ultimate conclusion reached by the Federal Circuit in this case, it also disagreed with the essential, underlying analysis applied by the Federal Circuit. In particular, in holding that respondent could not claim a depletion deduction based upon a "representative market or field price" that (as in the present case) significantly exceeds the price that respondent in fact received, the Tax Court directly rejected respondent's contention that the "plain language" of the regulation requires a different conclusion. 102 T.C. at 737-738, 743. It was precisely the "plain language" (Pet. App. 13a) of the regulation that the Federal Circuit found dispositive in the present case. The analysis applied by the Tax Court and the Federal Circuit on the question presented in this case thus differs diametrically and completely. The decisions of *both* courts quite obviously "bear on the question presented in the petition."

[2] A tax refund suit may be commenced only if the taxpayer has paid the tax in full (*Flora* v. *United States*, 362 U.S. 145, 177 (1960)) and may be brought either in district court or in the Court of Federal Claims. 28 U.S.C. 1346(a)(1), 1491. If a refund suit is brought in the Court of Federal Claims, any appeal is to the Federal Circuit. 28 U.S.C. 1295(a)(3).

outcome—based solely upon the taxpayer's ability to pay—warrants this Court's plenary review. In the absence of review by this Court, the conflict between the Federal Circuit and the Tax Court will arbitrarily yield more favorable tax consequences for taxpayers who are well-heeled than for those who are not.

3. Respondent devotes the balance of its brief to arguing the merits of the case. Although it is premature to address such contentions in detail, a few comments are appropriate.

a. The regulation provides that, when natural gas is not sold in the immediate vicinity of the well, the taxpayer's gross income is "assumed" to be equal to the representative price received by other sellers in the same field (26 C.F.R. 1.613-3(a)). Respondent renews the assertion—accepted by the Federal Circuit but rejected by the Tax Court—that the "plain language" of this regulation compels a decision that the representative field price is *always* to be applied in determining the depletion allowance for sales away from the wellhead. Indeed, respondent states that "the text is unequivocal, and its meaning is unmistakable" (Br. in Opp. 10). Ignoring both the Tax Court opinion in *Exxon* v. *Commissioner* and the petition filed in this case, Exxon asserts that "[t]he government * * * does not even attempt to advance an interpretation of the text that could support the result it seeks" (*ibid.*).

Respondent's forcefully phrased assertions should not be confused for analysis. As we explain in the petition,

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A taxpayer who wishes to challenge a tax *before* paying it must bring suit in the Tax Court within 90 days of the issuance of the notice of deficiency. 26 U.S.C. 6213(a); see *Flora* v. *United States*, 362 U.S. at 158-163. Any appeal from a Tax Court decision is to be lodged in the court of appeals for the circuit in which the taxpayer resides. 26 U.S.C. 7482(b). Thus, while any refund case may be brought within the Federal Circuit, no Tax Court case may be appealed to that circuit.

"the Tax Court correctly concluded [that] the text of the regulation does not compel only one interpretation" (Pet. 17):

> The fact that a particular price is to be "assumed" or presumed applicable under the regulation does not imply that this regulatory "assumption" or presumption is irrebutable. As the Tax Court stated, this language in the regulation does not refute the possibility that there are "circumstances under which it was * * * appropriate to apply an alternate method." *Exxon* v. *Commissioner*, 102 T.C. at 737-738; see also *id.* at 727 & n.10.

Because the "plain text" of the regulation is not unambiguous, the history and purpose of the regulation, as well as the agency's formal interpretation, should be given substantial weight in determining its meaning.

b. Under the express language of the statute, the percentage depletion allowance is to be based upon the "gross income from the property." 26 U.S.C. 613(a), (b). In Rev. Ruling 90-62, 1990-2 C.B. 158, the Treasury explained that, while the regulation specifies that a representative field price is to be "assumed" applicable for sales of natural gas "removed from the premises," if the price at which the gas is actually sold by the producer is "*less* than the [representative price]," the actual price received—rather than the "assumed" price—is to be used in calculating the deduction. In that situation, the actual price received best represents the "gross income from the property," as the statute requires. 1990-2 C.B. at 158-159 (emphasis added).

Respondent argues (Br. in Opp. 13-15) that the agency's interpretation is entitled to no deference because it was expressed in a Revenue Ruling—rather than in a regulation—and because the Ruling was issued during the

course of this litigation. Respondent's contentions are plainly incorrect.

(i) The "ultimate criterion" in construing a regulation is the agency's own formal interpretation, which is to be given "controlling weight." *Udall* v. *Tallman*, 380 U.S. 1, 16-17 (1965), quoting *Bowles* v. *Seminole Rock & Sand Co.*, 325 U.S. 410, 413-414 (1945). Revenue Ruling 90-62 qualifies for this deference because it represents the agency's formal interpretation of the statute and regulation that it addresses. The fact that a Revenue Ruling is not itself a "regulation" is irrelevant; an agency's interpretation of existing regulations is *ordinarily* set forth in rulings, not in amended regulations. Indeed, the cases cited in the petition—which respondent ignores—each involve the situation in which an agency has expressed its interpretation of its regulation in a subsequent ruling, rather than in a subsequent amended regulation. *E.g.*, *Lyng* v. *Payne*, 476 U.S. 926, 939 (1986) (a "staff instruction" that contains the "agency's construction of its own regulations is entitled to substantial deference"); *Udall* v. *Tallman*, 380 U.S. at 16 ("deference is * * * clearly in order" for a public order that sets forth "the construction of an administrative regulation").

(ii) The fact that Revenue Ruling 90-62 was issued after this lawsuit began does not deprive the Ruling of the "controlling weight" due to an agency's interpretation of its own substantive regulation. As this Court has emphasized, "neither antiquity nor contemporaneity" of the interpretation with the regulation "is a condition of validity." *Smiley* v. *Citibank (South Dakota), N.A.*, 116 S. Ct. 1730, 1733 (1996). Nor does it matter that the interpretation was prompted by the very litigation in which it is to be applied, for it is "absurd to ignore the agency's current authoritative pronouncement of what [its regulation] means." *Id.* at 1735 n.3.

Respondent contends that this Court's decision in *Smiley* is inapposite because that case involved a regulation that had been issued during the pendency of litigation to interpret the meaning of a statute (Br. in Opp. 14). But the analysis applied in *Smiley* is even more clearly appropriate in the context of this case for, as this Court stated in *Udall* v. *Tallman*, 380 U.S. at 16, "[w]hen the construction of an administrative regulation rather than a statute is in issue, deference [to the agency's interpretation] is even more clearly in order." In this case, as in *Smiley*, the agency's interpretation was the product of the agency's formal process that established the "official interpretation" of the regulation. 26 C.F.R. 601.201(a)(6).[3] The agency's interpretation is therefore entitled to "controlling weight." *Udall* v. *Tallman*, 380 U.S. at 17. See also Pet. 17 (citing cases).[4]

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[3] Revenue rulings are issued only with the participation and approval of the Chief Counsel of the Internal Revenue Service, the Commissioner of Internal Revenue and the Assistant Secretary of the Treasury (Tax Policy). Internal Revenue Manual, Chief Counsel Directive Manual (39)920, Revenue Ruling Handbook ¶¶ 720-725 (1988).

[4] Respondent notes (Br. in Opp. 12) that, in the court of appeals, the government argued that Revenue Ruling 90-62 set forth the Treasury's formal interpretation of the regulation but did not emphasize the "controlling weight" owed to the agency's interpretation. Although the Ruling was plainly addressed in the government's brief in the court of appeals, the government relied substantially on the reasoning and holding of the Tax Court in *Exxon* v. *Commissioner*, *supra*, which the court of appeals failed even to acknowledge, much less to address. Even if the Ruling had not been brought to the attention of the court of appeals, however, this Court's "traditional rule is that '[o]nce a federal claim is properly presented, a party can make any argument in support of that claim; parties are not limited to the precise arguments they made below.'" *Lebron* v. *National R.R. Passenger Corp.*, 115 S. Ct. 961, 965 (1995), quoting *Yee* v. *City of Escondido*, 503 U.S. 519, 534 (1992).

c. Respondent errs in stating (Br. in Opp. 19) that the term "gross income from the property" (26 U.S.C. 613(a)), upon which the depletion deduction is based, has some meaning different from the term "gross income" as used in other Sections of the Internal Revenue Code. In *Helvering* v. *Mountain Producers Corp.*, 303 U.S. 376, 382 (1938) (emphasis added), this Court held that "the term 'gross income from the property' means gross income from the oil and gas * * * *and the term should be taken in its natural sense*." Similarly, in *Crews* v. *Commissioner*, 89 F.2d 412 (10th Cir. 1937), the court of appeals held that depletion deductions could not be based upon hypothetical oil and gas proceeds (*id.* at 416):

> To allow a deduction on the basis of income never received and therefore no part of the gross income, on the net part of which a tax is exacted would be manifestly unfair. * * * [T]here should not be included in such gross income proceeds of oil never received by the taxpayer and no part of which became subject to income taxation.

Respondent is not entitled to a depletion deduction under Section 613 for amounts that exceed its "gross income from the property," that it never received and which never "became subject to income taxation" (*ibid.*). Under the theory of the court of appeals in this case, however (Pet. 19),

> instead of obtaining a depletion deduction of *22 percent* of the actual gross income that respondent received in 1979 * * *, respondent would obtain a depletion deduction equal to *114 percent* of its gross income from the properties in that year ($109 million deduction divided by $95 million in income).

Respondent is not claiming a deduction for merely a percentage of its gross income, as the statute permits. 26

U.S.C. 613(a), (b). Instead, respondent is claiming a deduction that *exceeds* its gross income from the property.

Contrary to respondent's contention (Br. in Opp. 17-19), prior to the decision of the Federal Circuit in this case, no court has ever allowed a taxpayer to compute its depletion deduction by reference to a "representative" field price that exceeds the taxpayer's actual gross income from the property. Even the decisions cited by respondent (*ibid.*) assume that the representative field price upon which the depletion deduction is based may *not* exceed actual gross income. See, *e.g.*, *Panhandle Eastern Pipe Line Co.* v. *United States*, 408 F.2d 690, 700 (Ct. Cl. 1969) (the percentage depletion allowance applies to "*only so much of the proceeds* from the sale of the gas as he would have received had he sold the gas at the wellhead"); *United States* v. *Henderson Clay Products*, 324 F.2d 7, 12 (5th Cir. 1963) ("when a taxpayer claims depletion on a fictitious gross income greatly in excess of its actual gross income, we find the claim highly indigestible"), cert. denied, 377 U.S. 917 (1964).

In describing the contention that a taxpayer may base depletion on "fictitious" income never received as "highly indigestible," these courts plainly do not support the decision of the Federal Circuit in this case. Exxon's contentions to the contrary (Br. in Opp. 18) are simply incorrect. See also *Exxon Corp.* v. *Commissioner*, 102 T.C. at 743 (the regulation "clearly was not designed to create 'income from the property' that far exceeded the taxpayer's proceeds").

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For the reasons stated above and in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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Acting Solicitor General

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